

OPTIMAL SHARI'AH GOVERNANCE MODEL IN ISLAMIC FINANCE REGULATION

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ABSTRACT

The Shari'ah governance is unique for Islamic financial institutions (IFIs), as it ensures that all activities of IFIs are in accordance with Shari'ah principles. At present, practices of Shari'ah governance in Islamic financial services industry vary from one jurisdiction to another. Nevertheless, three main Shari'ah governance models can be distinguished within this variety, namely, centralised, self-regulation and hybrid model. Today more and more countries are moving towards having a dedicated regulation to address Shari'ah governance framework, whereas a particular Shari'ah governance model will be chosen. This paper emphasises that Shari'ah compliance is the core element of Islamic finance and thus Shari'ah governance is a key factor to ensure such adherence. Furthermore, it advocates that the credibility of Shari'ah governance system and its effectiveness play vital role in the level of public confidence in Islamic finance. Having Central Shari'ah Board (CSB) with Shari'ah Supervisory Board (SSB) or only SSB was used as a distinguishing factor in classification of Shari'ah governance models. Each model of Shari'ah governance has its own advantages and disadvantages and these will be discussed in this paper. Subsequently, this paper proposes an optimal Shari'ah governance model to strengthen the weak aspects of the existing models.

Keywords: Islamic Finance, Shari'ah Governance, Shari'ah Advisory

1. INTRODUCTION

For the last 30 years, Islamic financial services industry has witnessed rapid growth and development around the globe. The demand for Shari'ah compliant products and services is ever increasing. Many countries amend their legislations in order to accommodate Islamic finance. Proper regulations together with the best practices of business conduct are the key factors for shareholders and public confidence in services and products offered by Islamic financial institutions (IFIs) in particular as well as in the whole industry in general. Recent studies indicate that Shari'ah compliance is essential factor in patronizing Islamic financial products and services (Gerrard & Cunningham, 1997; Okumuş, 2005; Rammal & Zurbruegg, 2007; Gait & Worthington, 2009; Sharif, 2011; Saini, Bick, & Abdulla, 2011; Hareem & Nadia, 2012; Abduh & Omarov, 2013). In other words, present and potential clients of IFIs opt not only for competitive Islamic financial

products and services as offered by conventional financial institutions, but also they demand their choice to be in line with the principles of religion of Islam, in accordance to the highest level of compliance as much as possible. Therefore there is a need for a build-in system that will assure Shari'ah compliance in all levels of financial business. This system is within the ambit of corporate governance.

Corporate governance refers to the method by which a corporation is directed, administered or controlled. Since IFI in many ways is similar to the conventional FI, the existence of a proper framework of corporate governance is a matter of dire necessity (Hasan A., 2007). However, different from conventional FI, IFI has the responsibility to ensure the compliance with the Shari'ah principles in its products, instruments, operations, practices, management, etc. This is done through Shari'ah governance, which is another component that is exclusive to IFIs.

Shari'ah governance is defined as "a set of institutional and organisational arrangements through which institutions offering Islamic financial services ensure that there is an effective independent oversight of Shari'ah compliance over the issuance of relevant Shari'ah pronouncements or *fatwa*, dissemination of information and an internal Shari'ah compliance review" (Islamic Financial Services Board, 2009).

Governance in all its aspects is paramount as it guarantees that an institution will be constantly on track, competent and able of reaching its goals, adhere to its own policies and strategies along with the best practices. Likewise, it preserves the enterprise from mismanagement, negligence, misbehaviours and adverse impact on its stakeholders. In addition, governance sustains confidence in the system. Whereas lack of confidence in the system will cause a systemic run on the organisations and, at last, the breakdown of the industry as a whole (Elasrag, 2014).

What is more, the importance of Shari'ah governance in Islamic finance cannot be overemphasized. Shari'ah compliance is the core element of Islamic finance, without which the whole industry will be in danger. It gives legitimacy to its practices. Besides, proper Shari'ah governance also boosts the confidence of the shareholders and the public that all the practices and activities are in compliance with the Shari'ah principles at all times. The existence of Shari'ah non-compliant element would affect, not only the confidence of the public in Islamic finance, but might also expose IFI to risks e.g. fiduciary and reputational risks (Laldin, 2012). Eventually, any failure or even defect in the aspect of Shari'ah compliance will surely distress the market and stakeholders confidence in Islamic finance as a whole. The compliance with the Shari'ah principles is achieved by having an effective and comprehensive Shari'ah governance framework, which is the crucial aspect in the distinctiveness of Islamic finance (Hasan A., 2007).

Therefore, after analysing the Shari'ah governance models practised around the world and what are the strengths and weaknesses of each model, this paper aims to highlight a proposal of an optimal Shari'ah governance model. It is organised into several sections. The following section describes models of Shari'ah governance. The third section analyses advantages and disadvantages of each model. The fourth section provides recommendations for a better Shari'ah governance model. A brief conclusion is offered in the final section.

2. MODELS OF SHARI'AH GOVERNANCE

At present, practices of Shari'ah governance in Islamic finance industry vary from one jurisdiction to another. However, all of them can be classified into three main models:

1. Centralised model. Countries that implement this model have central higher Shari'ah authority to govern matters pertaining Islamic finance. Central Shari'ah authority named differently in various jurisdictions, therefore, in this research it is referred to as Central

- Shari'ah Board (CSB). Shari'ah pronouncements of CSB are binding to IFIs. Depending on jurisdiction there can be one CSB for all sectors of Islamic finance industry, e.g. banking, takaful, capital market (for example, Indonesia, Pakistan), or CSB with each government agency or authority governing particular sector (for instance, Malaysia) (Wilson, 2011).
2. *Laissez-faire* or self-regulation model is practised in some GCC countries (such as Saudi Arabia, Qatar, UAE and Kuwait) as well as the countries with Muslim minority population (e.g. UK, Singapore, USA), or jurisdictions, which just recently adopted special legislation for Islamic finance (among them some of the Commonwealth of Independent States (CIS) countries like Kazakhstan and Kyrgyzstan). Countries that adhere to this model do not have CSB to govern matters pertaining Islamic finance. Nonetheless, each IFI has its own Shari'ah Supervisory Board (SSB) to ensure compliance of the business with Shari'ah rulings (Hassan, et al., 2013).
 3. Hybrid model. This model is unique to Bahrain. In this jurisdiction the functions of CSB are limited to advisory and supervision of the central bank activities related to Islamic finance. CSB is not the highest authority when it comes to Shari'ah rulings; hence IFIs operate according to the Shari'ah pronouncements of their own SSBs (Hasan Z., 2010).

2.1. Centralised model

Using this model, government regulates Shari'ah advisory and supervision on a central level. It is made possible through legislation or specific government provisions, where the role and functions of CSB (or CSBs of respective government financial agencies or authorities) are clearly stipulated by the Law. Consequently, as previously stated, CSB is considered as the ultimate authority pertaining Shari'ah matters in Islamic finance. Its Shari'ah pronouncements generally carry legal nature, hence, are binding and enforceable to IFIs of a country. If there is a case where Shari'ah pronouncement of any SSB of any IFI in the country contradicts to the one made by CSB, then Shari'ah pronouncement of CSB shall prevail and SSB should amend its Shari'ah pronouncement accordingly (Hassan, et al., 2013).

Moreover, Shari'ah governance structure as well as process and functions are commonly specified and regulated by the government. Each jurisdiction has specific features and characteristics of Shari'ah governance structure, though in general simplified common structure is as follows. There is CSB at the national level, members of which are usually appointed by the government authority. At the institutional level each IFI has SSB, members of which are appointed by the board of directors (BOD) or the annual general meeting of the shareholders (AGM) of a respective institution (Hasan Z., 2010).

In some jurisdictions, the process of appointment of members of CSB is subject to certain restrictions and parameters. For example, in Malaysia:

- members of CSB should be individuals;
- CSB should comprise of at least five members;
- members of CSB should be appointed for a particular tenure, which can be renewed after its ending (Central Bank of Malaysia Act, 2009; Central Bank of Malaysia, 2010).

SSB members' appointment process has similar parameters as of CSB, however, there are some differences:

- members of SSB should be individuals;
- SSB usually comprises of at least three or five members, however in some jurisdiction minimum number of SSB members is one;

- members of SSB should be appointed for a particular tenure, which can be renewed after its ending;
- appointment of SSB member of an IFI is usually pending upon approval from CSB (Central Bank of Malaysia, 2010; Hassan, et al., 2013).

Member of CSB or SSB, who can also be called as Shari'ah advisor should satisfy certain requirements:

- should possess necessary knowledge, expertise or experience in the principles of Islamic jurisprudence (*usul al-fiqh*) and Islamic commercial law (*fiqh al-mu'amalat*);
- should have knowledge, expertise or experience in finance, economics, banking, law or other related disciplines;
- should retain strong Islamic moral values;
- should not be a significant shareholder of an IFI of the same category;
- should not hold an executive position in an IFI of the same category;
- should not be a member of BOD of other IFI of the same category;
- should not be involved in a fraud, or a serious crime or an activity against principles of Shari'ah or an activity, which severely damages the reputation (Central Bank of Malaysia, 2010; Hassan, et al., 2013).

Some jurisdictions on top of aforesaid requirements set additional restrictions. For example in Malaysia and Nigeria, member of CSB is not allowed to be a member of SSB of an IFI governed by that CSB (Hassan, et al., 2013; Momodu, 2013). Not only that, member of SSB of an IFI is not allowed to be member of SSB of another IFI of the same category. To elaborate, member of SSB of an Islamic bank is not permitted to be a member of SSB of another Islamic bank, however, membership in SSB of a takaful company or a fund management company is acceptable (Hasan A., 2007; Hasan Z., 2010; Wilson, 2011).

An interesting point to be put forward is that aforementioned parameters and restrictions applicable only within certain particular country. This is because the dominion of jurisdiction of a particular country law is limited to that country and usually does not apply cross-border, except there are international agreements between some countries. The consequence of this can be best described by a case when a member of CSB in one country is a member of SSBs of two respective Islamic banks in two different countries and at the same time is a member of BOD of an Islamic bank in a forth country.

Functions of CSB may vary from country to country; nonetheless there are some common points, which are as follows:

- establishment of Shari'ah rulings pertaining to Islamic financial transactions;
- advice of financial authorities of a country on any matters related to Islamic finance;
- approval of regulations, guidelines and standards issued by financial authorities in regard to Islamic financial activities;
- delivering opinions pertaining the nomination or revocation of members of SSBs (Hassan, et al., 2013).

On the other hand, functions of SSB are:

- to advice management of IFI pertaining business operations to ensure that all activities and products offered are in line with Shari'ah rulings;
- to be responsible and accountable for all Shari'ah pronouncements made by the members of SSB;
- to endorse Shari'ah policies and procedures of IFI;
- to endorse documentations involved in business activities of IFI;
- to asses work performed by Shari'ah audit, review and research departments or divisions of IFI;
- to advice management of IFI to seek for advice from CSB on Shari'ah matters that are not resolved by SSB;
- to assist auditors, consultants or legal counsels by providing advice regarding Shari'ah rulings (Central Bank of Malaysia, 2010; Laldin, 2012; Hassan, et al., 2013).

2.2. Self-regulation model

Currently, this model of Shari'ah governance is more prominent compared to the previous one. The number of countries that use it is more than those adopted the centralised model. There are few reasons describing this fact.

- Some countries do not have specific legislation for Islamic finance, thus there is no official recognition of Islamic finance as a specific sector.
- Some jurisdictions despite the fact of having special provisions to accommodate Islamic finance are secular in nature. Due to this, the financial authority of a country cannot incorporate CSB, which is a religious body.
- Some jurisdictions prefer minimalistic approach allowing more flexibility and relying more on market discipline and best practices. In the case of UAE, although the Law stipulates the establishment of country's CSB, which is called Higher Shari'ah Authority, the very existence of it remains in theory (Hassan, et al., 2013).

In some jurisdictions with specific legislation related to Islamic financial activities, financial authorities provide specific provisions on a matter of Shari'ah governance process and functions, for instance, IFIs are obliged to follow AAOIFI Governance Standards for IFIs (Accounting and Auditing Organization for Islamic Financial Institutions, 2005). Meanwhile, in some other countries with a law related to Islamic finance there are no specific provisions on a matter of Shari'ah governance, however IFIs are required to have their own internal policies and procedures regarding Shari'ah governance process and functions. Usually, IFIs are recommended to follow IFSB (Islamic Financial Services Board, 2009) and AAOIFI Governance Standards for IFIs (Accounting and Auditing Organization for Islamic Financial Institutions, 2005). On the other hand, IFIs operating in countries with no specific law on Islamic finance are totally self-regulated in terms of Shari'ah governance. Be that as it may, IFIs are forced by the market to have proper Shari'ah governance process and functions. There are certain parameters for SSB members' appointment process:

- members of SSB should be individuals;
- SSB usually comprises of at least three or five members, however in some jurisdiction minimum number of SSB members is one;
- members of SSB should be appointed for a particular tenure, which can be renewed after its ending

- SSB functions could be outsourced to a company, which has Shari'ah expertise (Laldin, 2012).

Members of SSB are usually appointed by the board of directors (BOD) or the annual general meeting of the shareholders (AGM) of a respective institution. The requirements for Shari'ah advisors are similar to those in centralised model, however there are less restrictions. In general, Shari'ah advisor should satisfy following requirements:

- should possess necessary knowledge, expertise or experience in the principles of Islamic jurisprudence (*usul al-fiqh*) and Islamic commercial law (*fiqh al-mu'amalat*);
- should have knowledge, expertise or experience in finance, economics, banking, law or other related disciplines;
- should retain strong Islamic moral values;
- should not be involved in a fraud, or a serious crime or an activity against principles of Shari'ah or an activity, which severely damages the reputation (Laldin, 2008; Hassan, et al., 2013).

Some jurisdictions on top of aforesaid requirements set additional restrictions regarding membership in SSB. Member of an SSB:

- should not be a significant shareholder of an IFI of the same category;
- should not hold an executive position in an IFI of the same category;
- should not be a member of BOD of an IFI of the same category (Wilson, 2011; Hassan, et al., 2013).

Functions of SSB are determined by each IFI. Nevertheless, the following functions are in common practice:

- to advice management of IFI pertaining business operations to ensure that all activities and products offered are in line with Shari'ah rulings;
- to be responsible and accountable for all Shari'ah pronouncements made by the members of SSB;
- to endorse Shari'ah policies and procedures of IFI;
- to endorse documentations involved in business activities of IFI;
- to assess work performed by Shari'ah audit, review and research departments or divisions of IFI;
- to assist auditors, consultants or legal counsels by providing advice regarding Shari'ah rulings (Thiagaraja, Morgan, Tebbutt, & Chan, 2014).

2.3. Hybrid model

As previously stated, this model is practised in Bahrain, where the Central Bank of Bahrain (CBB) has its own SSB as any other IFI in the country. SSB of CBB is not called as CSB because its functions are limited to only advice and supervision of CBB on matters pertaining Shari'ah. Furthermore, SSB of CBB does not serve as the supreme authority for Shari'ah rulings in Islamic finance. The CBB rulebook makes specific reference to AAOIFI Governance Standards for IFIs (Accounting and Auditing Organization for Islamic Financial Institutions, 2005), therefore, IFIs are required to follow these standards in terms of Shari'ah governance. Shari'ah governance process and functions, as well as requirements for members of SSB are similar to those in *laissez-faire* model (Hassan, et al., 2013).

3. ADVANTAGES AND DISADVANTAGES OF MODELS

Each Shari'ah governance model has its own advantages and disadvantages. Since the hybrid model is similar to self-regulation model only two models are taken into consideration, namely centralised and self-regulation model.

3.1. Advantages and disadvantages of centralised model

First and foremost centralised model provides standardisation and harmonisation of practices in Islamic finance, especially the Shari'ah pronouncements, at least within a particular jurisdiction. It promotes consistency and certainty of rulings on Shari'ah issues and reduces the Shari'ah non-compliance risk, which in its turn raises the confidence of customers in products and services offered by IFIs of that country.

Furthermore, this approach may potentially prevent from a lot of confusion and conflicts within different SSBs. Since SSBs are supervised by CSB (even on the appointment, resignation and termination of SSB members), there is less potential for conflict of interest because IFIs are not just paying their own handpicked advisors for services that only favourable for IFI's business. In other words, there is no room for so called 'fatwa shopping' (Mohamad & Trakic, 2012).

This model may also assist for further development of Islamic finance in general. This has been demonstrated by Islamic Finance Development Report 2014 (ICD, Thomson Reuters, 2013), whereby Malaysia with its centralised Shari'ah governance model was rated the best jurisdiction in Global Islamic Finance Development Indicator. Many things may be said to contribute to this; one of these is arguably the centralised Shariah governance model which help to accelerate further the industry due to its transparency and certainty.

Having legal authority within a particular jurisdiction, which has the right for final approval of new products and services offered by IFIs, assures validity of Shari'ah pronouncements. In most other jurisdictions, where self-regulation Shari'ah governance model is practised, the status of Shari'ah rulings for Islamic financial contracts remains ambiguous and vague when it comes to enforcement under the law. Besides that, reference to CSB in the process of dispute resolution whether by means of litigation, arbitration or mediation helps to resolve disputes in more efficient manner and what is more important taking into account Shari'ah view on each particular problem (Oseni, 2009; Mohamad & Trakic, 2012).

Moreover, acknowledging that the expertise in Shari'ah is relatively limited, the establishment of a CSB enables all market players to benefit from the scholars of top calibre who sit on CSB. At the same time it may ease the burden on individual SSBs as they can anticipate the guidance from CSB. It is known from history of Islamic states that judges used to resort to high-profile esteemed scholars for the rulings on specific cases (BMB Islamic, 2011).

Furthermore, in the jurisdictions with centralised Shari'ah governance model where Shari'ah advisors are restricted to serve as Shari'ah board members of only one IFI of the same industry, different IFIs must employ different Shari'ah advisors. This limitation serves as a reason for creation of more Shari'ah scholars, new talents development and further progress of the Islamic financial services industry.

Among disadvantages of centralised model that might be stated is limitation of *ijtihad*. According to Imam Al-Zarkashi, *ijtihad* is "the exertion of effort in order to obtain the Shari'ah ruling through the application of a particular method of derivation" (Al-Zarkashi, 1993). In other words, *ijtihad* is a process of derivation of Shari'ah rulings on certain issues. With a CSB, there is a chance that Shari'ah advisors of the CSB will give a particular opinion at the expense of others. This will limit the independency of *ijtihad* for the Shari'ah advisors at the SSB level; also they

would not be able to have different opinion due to the binding nature of the resolution made by the CSB. Then a narrow stance will outline the parameters of Islamic finance and not have the independent and democratic character, as it is evident presently.

To reiterate, since the Shari'ah pronouncement of CSB is binding on SSBs, it might be seem that *ijtihad* is limited and there is no free room for innovation. Though this is likely to happen, to solve this problem, there shall be a proper mechanism to resolve this issue. For example, if a SSB comes up with a new product or a new structure, hence new Shari'ah ruling, a proper mechanism for further discussion and deliberation with the CSB shall be facilitated. And if the SSB can defend its opinion before the CSB, on reasonable grounds the CSB shall change its Shari'ah opinion. Similarly, a *fatwa* issued by the CSB should be reviewed if it is found that the circumstances in which it was issued or the market conditions have changed (Al-Zuhayli, 1989). Another interesting point that needs to be highlighted that more often than not members of CSB in general are more experienced than average members of SSB as well as concern of CSB members is the whole Islamic financial system and its stability, unlike SSB members whose most concern is 'Shari'ah compliant' benefit of an IFI employed them (Hasan A., 2009). As such, continuous process of engagement is necessary and a proper mechanism for that shall be accommodated.

In the same vein, there is an issue of the 'time to market'. To explain further, the process for Shari'ah approval of a new product or service does not only depend on a SSB, but also requires approval of the CSB. In other words, any approval of a product will require approval of two bodies (SSB and CSB) is needed, unlike in the case of self-regulation model. If this process is not managed well, it will lead to a longer period of approval, which may affect the timing of a product to be launched.

Another disadvantage of this model is that it can be applicable only in some jurisdictions where there is specific legislation for Islamic finance. On top of that there should be special provisions regarding CSB. Therefore, application of this model is very much dependant on the law of a country. Also, the practice of CSB may not be possible or burdensome in jurisdictions whereby Islamic finance is still at infancy stage, like the UK, Singapore etc. Hence, its practice may take a longer time and probably more efforts need to be made to effect changes to the law of the countries to make it doable.

3.2. Advantages and disadvantages of self-regulation model

When it comes to applicability of the model, *laissez-faire* one surpasses centralised Shari'ah governance model. This is due to the fact that there is no need in special provisions in the law of a particular country for implementation of self-regulation model. If there is possibility of having Islamic finance, or there are already some IFIs performing their business activities, that already means self-governance model has been implemented.

Moreover, as formerly mentioned, the timing of Shari'ah approval of a product to be launched in the market depends only on SSB. For this reason, relatively, IFIs in self-regulation model are able to launch their new products and services faster compared to centralised model. Taking into account of severe competition with conventional FIs, it is very much important for IFIs to launch new competitive products at the same pace, if not faster, with the conventional counterparties, as any delays might prevent IFIs to attract more customers. Duration of the process of Shari'ah approval therefore plays a vital role in the whole process of a product launch.

Another advantage of this model is that it provides more possibilities for *ijtihad*, i.e. it opens a door for more *ijtihad*. Since SSBs are not bound to follow certain Shari'ah opinion, for example imposed by CSB, they might come up with a new Shari'ah ruling that is very innovative in nature

and at the same time suitable for the current circumstances and market conditions although it may differ with other SSBs' Shari'ah pronouncements regarding the same particular issue.

Nevertheless, at the same time this model lacks of standardisation and harmonisation. Variety of Shari'ah rulings differing from one SSB to another and sometimes contradictory to each other reduces certainty in the practice of Islamic finance. Eventually it might cause confusion among stakeholders to the merits and authenticity of the industry. This issue becomes very sensitive especially when it comes to cross-border transactions. Yet, standardisation or harmonisation of Shari'ah rulings on a global scale is itself a separate issue, which has been discussed and debated since the emergence of modern Islamic finance (Zaidi, 2008).

Not only that, with the absence of the higher Shari'ah authority to supervise SSBs, IFIs might employ only those Shari'ah advisors who will only issue *fatwas* favourable for the institution. In other words, it opens space for the '*fatwa shopping*', reducing confidence of the stakeholders (Malik, Malik, & Mustafa, 2011). However, to boost confidence of the market, many IFIs tend to employ mostly Shari'ah advisors of top calibre. This in its turn brings another issue, when top twenty Shari'ah advisors serve more than a half of all Shari'ah boards of IFIs around the world (Ünal, 2010). If in some jurisdictions with central Shari'ah governance model this issue is solved by putting restrictions that each Shari'ah advisor can be a member of SSB of only one IFI in each sector, on the other hand, in self-regulation model there is yet no body or authority to impose such restrictions.

4. PROPOSITIONS FOR A BETTER SHARI'AH GOVERNANCE MODEL

As previously discussed, each governance model has its own strengths and weaknesses. Moreover, there is no one model fits all, as some countries have specific provisions pertaining the structure of Shari'ah governance and the rules of its execution, whilst others may have their own circumstances in adopting certain governance framework, instead of the other. Obviously, centralised model may not be suitable in some jurisdictions like USA, UK, Russia, Singapore, etc. Nonetheless, the authors believe that there is a need to apply the best practices in Shari'ah governance for IFIs. Taking into account the level and pace of the Islamic finance development, Shari'ah governance framework may vary from one country to another. The Islamic financial services industry is notably still in its infancy stage, especially in certain jurisdictions, especially in the west. Therefore, any rigid, rule-based approach adopted in haste aiming at strengthening the governance of the industry may jeopardise and hinder its potential and healthy growth. Another important point that needs to be highlighted is that "the Shari'ah governance structure adopted by the IFIs should be commensurate and proportionate with the size, complexity and nature of its business" (Islamic Financial Services Board, 2009). However, some common elements that underlie good governance and best practices may be drawn to facilitate the creation and to optimise a healthy and viable environment for Shari'ah governance without impeding further growth of the industry.

Pertaining to this, the endeavours of various institutions on a matter of providing extensive Shari'ah governance should be given due respect and should be followed. Among them Guiding Principles on Shari'ah Governance (Islamic Financial Services Board, 2009), Governance Standards for IFIs (Accounting and Auditing Organization for Islamic Financial Institutions, 2005), including regulators such as Central Bank of Malaysia who issued Shari'ah Governance Framework for IFIs (Central Bank of Malaysia, 2010).

As previously discussed, to foster the growth and the comprehensive development of the Islamic financial industry in a particular jurisdiction, the establishment of the CSB by way of promulgation of law may be a viable measure. With that, it is important to accord the final Shari'ah

authority to the CSB in matters relating to Islamic finance. Furthermore, there should be regular and proper mechanism to ensure communication between the CSB and SSBs to exchange ideas and share experience. This will enhance the dynamic of Shari'ah advisory in Islamic finance.

Among other aspects that need to be highlighted are the issue of qualifications and restrictions for the appointment of a CSB or a SSB members. As for restrictions, though some of these aspects are already in practice, the authors wish to recommend the following parameters to be followed:

- CSB should comprise of at least five members, preferably with various expertise. This combination will ensure that the decisions are made after thorough process of analysis and discussion among the members;
- SSB should comprise of at least three members, however, if the business of an IFI is relatively small, one Shari'ah advisor might be enough. However, a rigorous Shari'ah governance framework must be put in place to ensure that any Shari'ah opinion made has gone through the right process and procedure. Nevertheless, with the expansion of business, the number of appointed Shari'ah advisors should increase in order to address Shari'ah matters pertaining IFI activities accordingly;
- members of CSB or SSB should be appointed for a particular tenure, which can be renewed after its ending;
- appointment and termination of a SSB member should be done by a body which is independent from the management, like Board of Directors, General Assembly, or if there is a CSB, should be made by the CSB;
- A proper code of ethics should be formulated and be followed by the Shari'ah advisor. The implication of this is that Shari'ah advisor is a very much respected, reputable and trustworthy person. Therefore, safekeeping and protecting of his image and reputation is very much important.

As for restrictions that should be imposed on members of a CSB, the authors are of the view that they should not be allowed to serve any IFI governed by that CSB because a situation of conflict of interest may occur when a product or instrument of a particular IFI is brought up to the CSB for the approval. Nonetheless, there might be some drawbacks of this point of view, such as obsolescence of the knowledge of the members of the CSB, deprivation of the market from 'good brains' and no interaction between experienced and inexperienced Shari'ah advisors. The solution for these shortcomings will be discussed further below. The practice of country like Malaysia can serve as good example for the case study.

On top of that, following the experience of Malaysia, it is good to have classification of the industries into Islamic banking, takaful and Islamic capital market in order to allow Shari'ah advisor to serve only one Islamic bank and one takaful provider at a particular time. To elaborate, member of a SSB of an Islamic bank is not permitted to be a member of a SSB of another Islamic bank, however, membership in a SSB of a takaful company or a fund management company is acceptable. Meanwhile, when it comes to one-off products like sukuk for example, there should not be restrictions on numbers of products or IFIs for which Shari'ah advisor is assigned, because there is no continuous advisory relationship between the advisor and the financial institution that he advised on sukuk.

Subsequently, member of a SSB:

- should not be a significant shareholder of an IFI of the same category including the one where he serves as a member of the SSB;
- should not hold an executive position in an IFI of the same category including the one where he serves as a member of the SSB;
- should not be a member of a BOD of other IFIs of the same category;
- should not be a member of a SSB of other IFIs of the same category.

It is interesting to note that the aforementioned restrictions like not being a significant shareholder of an IFI or not holding an executive position in the same IFI that he serves as member of the SSB are meant to preserve independence of Shari'ah advisor so as to avoid biased decision made by Shari'ah advisor. Meanwhile, it is also recommended that one of the SSB members to be appointed as a member of the BOD that could serve as a 'bridge' between the BOD and the SSB. The presence of a director with sound Shari'ah knowledge would foster a greater understanding and an appreciation amongst the board members on the decisions made by the SSB.

Another concern is the issue of conflict of interest, in other words secrecy and confidentiality of trade secrets when a Shari'ah advisor either serves as SSB member of more than one IFI in the same category, holds significant portion of shares, holds executive position or serves as a member of BOD of other IFIs of the same category (Elasrag, 2014). This problem should be addressed with full gravity as it is faced in different countries, especially those that practice self-regulation Shari'ah governance model.

It is not a secret that in an industry with over 500 Shari'ah advisors, there are top twenty highly demanded Shari'ah advisors who sit on more than a half of all SSBs around the world (Ünal, 2010). Of course, this is to a great extent because of their skills, expertise, reliability and credibility and lack of same calibre of experience and qualification Shari'ah advisors in the market. Furthermore, perception of stakeholders also plays its role. When they know that products of a particular IFI are endorsed by one of these top twenty Shari'ah advisors, they feel more comfortable to accept the endorsement. Notwithstanding this, there is severe criticism of this fact as it creates a cartel like market. In other respects it also reduces opportunities for more 'new brains' to enter the market, decreases the potential for the growth and innovation together with the efficiency. Not only is there scope for conflicts of interests but more worryingly as of duties. The consequence of this is the lack of due diligence. Trying to be realistic, one Shari'ah advisor cannot supervise hundreds or even tens of IFIs with adequate due diligence. The bigger pressure on advisors to review and report on time leads to inefficiency due to superficial reading of the documents or outsourcing to individuals or advisory institutions without the vital experience (BMB Islamic, 2011). Even though there are no evidences that these problems have occurred, there is no assurance that they might not occur in the future.

Another concern that needs proper attention and emphasis is once again the reliance on only a small group of scholars thereby reducing the opportunities for new scholars to develop experience and knowledge. Countries like Malaysia and Nigeria already started to solve this problem by setting restrictions whereby Shari'ah advisors can sit only on one SSB in each category (Hasan Z., 2010; Momodu, 2013). This opens room for new talents benefiting both IFIs particularly and the Islamic financial industry in general.

Be that as it may, the problem cannot be properly solved only by the way of putting restrictions. Unfortunately there is big number of Shari'ah scholars who do not possess sufficient knowledge of financial matters. It causes difficulty in effective analysis of the matters regarding Islamic finance and subsequently making it hard to issue comprehensive *fatwas* (Laldin, 2012).

Therefore, initiatives such as educational and training programs specifically developed for Islamic finance professionals including Shari'ah advisors are very important to ensure that adequately versed Shari'ah scholars who are competent in both conventional finance and Shari'ah are there to meet the demand of the industry. Some countries like Malaysia and Bahrain have acknowledged the importance of such measures as they provide a platform for interaction with exchange of ideas and experience between academics and finance practitioners with Shari'ah scholars, granting all parties a deeper insight into details of financial products and services as well as Shari'ah rulings (Thiagaraja, et al., 2014).

At the same time there is a need for interaction between experienced and inexperienced Shari'ah advisors. To address this issue it is suggested to establish association of Shari'ah advisors at first in each particular country to oversee their practices and ensure professionalism among Shari'ah advisors and experts of Islamic finance together with enhancement of knowledge and competency of the members of the association through training and continuous professional development. At the same time, since Shari'ah advisory is a profession that requires public trust together with the highest levels of integrity and competence, such body may be given a mandate to issue professional certification to ensure competency of Shari'ah advisors as well as the best professional, educational and ethical conduct at all times.

It is through this type of association collaboration between high calibre CSB members and other Shari'ah advisors can be achieved, allowing the market to benefit from this synergy. This is the way of solving the downsides of restricting members of CSB to serve in SSBs of IFIs. Again, Malaysia may serve as a good example with the Association of Shari'ah Advisors in Islamic Finance Malaysia (ASAS).

Having acknowledged human shortcomings, the authors are convinced that burdening a Shari'ah scholar with all aspects of financial business is unwise. Trying to be rational, it is absurd to believe that a person is equipped with all aspects of financial business like legal, tax, Shari'ah and marketing capability; this would be difficult if not impossible to be found in one person. Nevertheless, it has to be accepted that a certain level of knowledge relating to legal, regulatory and taxation framework, product structuring skills and other related disciplines is inescapable for Shari'ah advisors in carrying out their duty successfully. Besides that, Shari'ah advisors must also possess certain qualities (Hasan A., 2009). Below are some of necessary components, which the authors believe are a must for a high quality Shari'ah advisor (this list is not meant to be exhaustive):

1. Academic criteria. A Shari'ah advisor must enjoy these criteria:

- mastery of both Arabic and English languages;
- mastery of a language of a business conduct of a country where Shari'ah advisor is a member of SSB of an IFI;
- knowledge, expertise or experience in the principles of Islamic jurisprudence (*usul al-fiqh*) and Islamic commercial law (*fiqh al-mu'amalat*);
- knowledge, expertise or experience in finance, economics, banking, law or other related disciplines.

2. Sustainability criteria:

- innovative and forward looking nature;
- willingness to learn and share;
- willingness to acknowledge Shari'ah views;
- ability to absorb pressure;
- high benchmark;

- strong Islamic moral values;
- humble and able to admit shortcomings.

5. CONCLUSION

The importance of Shari'ah governance in IFIs is undeniable. Proper mechanism and framework need to be created to enable proper advisory and supervisory role of CSB and SSBs. Integration between the CSB and SSBs of IFIs should be facilitated to provide a conducive environment for better Shari'ah governance. The scope of advice and supervision must include both micro and macro issues of IFIs. Proper framework should be put in place to ensure optimal Shari'ah governance of IFIs

- on the appointment of CSB and SSB members, relationship between the two bodies, membership, procedures, qualifications, etc.;
- on the scope of advice and supervision, it should be a holistic approach, looking not only at particular contracts or structures, but on the operations of an IFI as a whole, covering before, during and after the execution of all products and structures.

Constant enhancement of the framework is necessary to ensure optimal Shari'ah governance in Islamic finance. Existing and potential problems like conflict of interest should be addressed. It is generally known that in order to reduce the possibility of conflict of interest the codes of conduct of lawyers or accountants are subject to strict and stringent rules. The Islamic financial services industry should not disregard the conventional finance industry best practices developed and enhanced from years of experience. As a young and ever growing industry, it has to learn from mistakes of the conventional financial industry, and act accordingly.

There is still a need in injection of a critical mass of new Shari'ah scholars into the industry to stimulate change and improve the integrity. A talented group of esteemed scholars may transfer their skills and knowledge to a wider group of upcoming scholars through the platform of Shari'ah advisors associations, providing opportunities for them to get into the industry.

All in all, effective Shari'ah governance is not only Shari'ah advisors responsibility but also it is responsibility of all stakeholders of the Islamic finance industry. Shortcomings in Shari'ah governance cannot be easily tolerated as they might result in intrusion of Shari'ah non-compliance elements exposing IFIs to fiduciary and reputational risks. Eventually, any failure or even defect in the aspect of Shari'ah compliance might pose a grave danger to the industry as a whole. Therefore, various parties should participate and contribute to the improvement of the existing Shari'ah governance practices.

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